

DOW THEORY LETTERS INC.

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36 Letters per Year — \$95 Annually

Registered with the Securities Exchange Commission

January 15, 1975

Letter 619

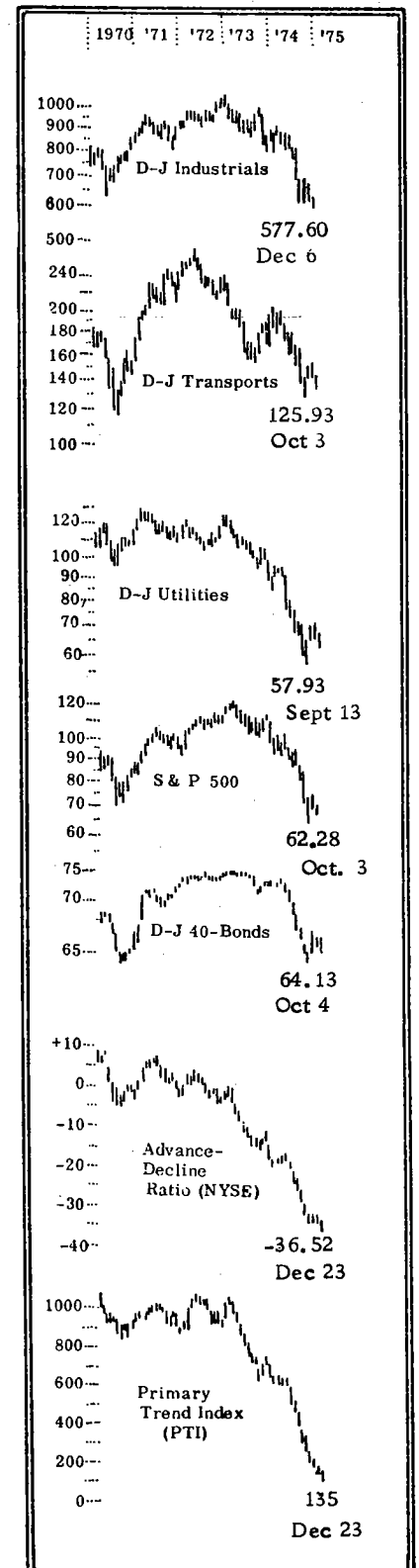
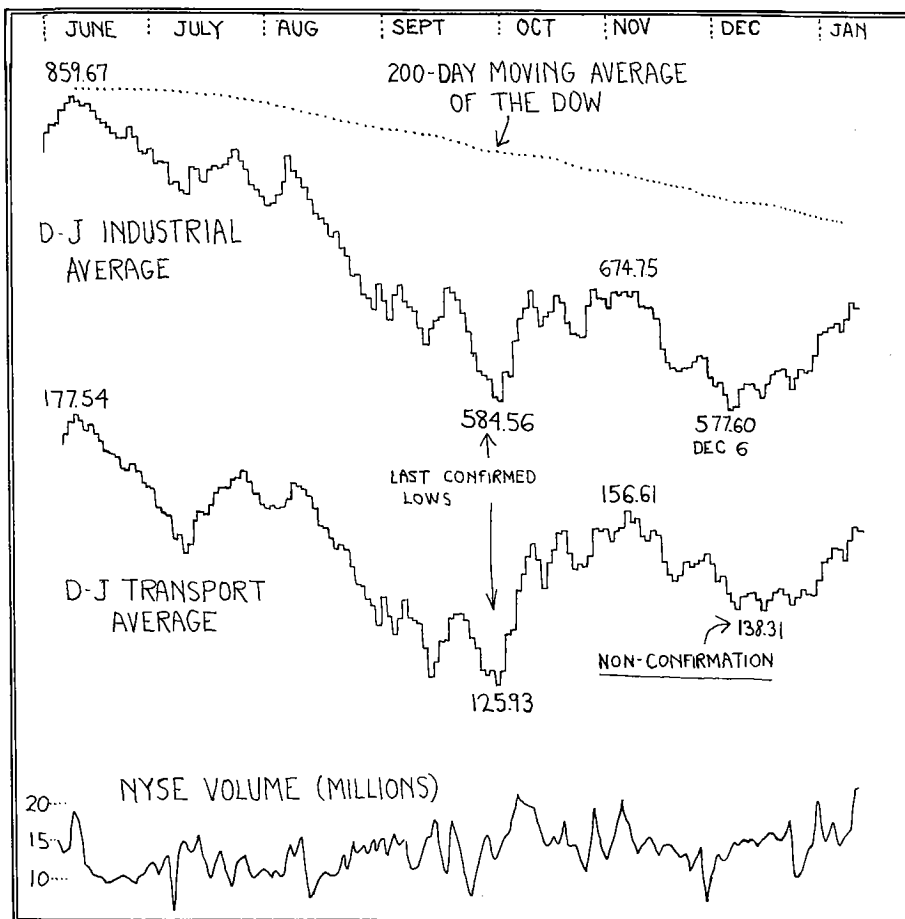
Jan. 3, DJIA 634.54; PTI 143; A-D ratio -34.59

Jan. 10, DJIA 658.59; PTI 163; A-D ratio -32.88

"New opinions are always suspected, and usually opposed, without any reason but that they are not already common."
John Locke (1690).

I want to start this Letter off with a concept that was always on Charles Dow's mind, the concept of change. In 1902 Dow wrote, "There is always a disposition in people's minds to think that existing conditions will be permanent. When the market is down and dull, it is hard to make people believe that this is the prelude to a period of activity and advance. When prices are up and the country is prosperous, it is always said that while preceding booms have not lasted, there are circumstances connected with this one that make it unlike its predecessors and give assurance of permanency. The one fact pertaining to all conditions is that they will change."

Two emotions rule the market and a third phenomenon seems to constitute the foundation. The two emotions are fear and greed. At the bottom or during great declines, fear takes over, and people who swore that they "would never sell" dump their long-held shares "for tax reasons" or some other nonsense that they tell themselves. At the top of an extended advance people rush in to buy, because they are greedy and they have succeeded in convincing themselves that what has been happening will continue to happen, and why not get in on all this "fast and easy money". The veteran market practitioner learns to control these two emotions — if he doesn't, he ends up wearing patched pants and peek-a-boo shoes. It's as simple as that.



Page 2 Behind everything, I believe, lies the average man's extraordinary desire for safety. Fear is a feeling that one's safety is in jeopardy. Greed is a feeling that if you don't grab it all, you are not going to be safe, that you won't survive. The obsession with safety makes men want to hang on to the status quo, hang on to what they know and are used to. Thus, I have seen men living in the worst slums who entertain no thought of leaving. I have seen other men killing themselves to protect jobs that they hate. I have puzzled over this, and I have come to the conclusion that these men prize what they know, what they are used to, and this implies that they choose safety above all. They fear change, they resist change, they are unwilling to comprehend the concept that change is inevitable.

It is for this same reason that so few people are able to (or want to) recognize a change in the primary trend of the market, from bull to bear or from bear to bull. The change seems unbelievable to them, it seems scary. For if it's true, they will have to move, sell some things, buy others, make new decisions. That scares them, so they continue to read the newspaper headlines and anything else that will confirm their need for surety ("non-change"), and they quietly lose their money. It's worth pondering.

THE PICTURE: This is how US News & World Report (Jan. 6, 1975) assessed the picture as we enter the new year:

Entering 1975, businessmen almost everywhere are gripped by anxieties and gloom rarely matched in decades. The most optimistic say business will pick up --but not for months. The pessimists see, at best, another year of stagnation.

Steep oil costs, other inflationary prices and wage hikes are shattering corporate budgets, putting profits in peril. Money is costly. Investment by industry is sluggish. Consumers pinch pennies. Bankruptcies crowd the courts.

In the face of the worst gloom and despair since World War II, I recently reversed (in November) my bearish stance toward the stock market, a stance that I have held for many years. Moreover, I stated that the public psychology, the news background, the warnings of politicians, the anguish of the investment fraternity, ALL suggested that the background was ripe for the birth of a new bull market. Last month a seat on the NYSE sold for \$70,000, down 86.5% from the lofty \$515,000 peak of 1968. Does anyone need further proof that Wall Street itself is one of the greatest sufferers during a primary bear market collapse? Today in San Diego one can see the following motion pictures: "Juggernaut," "The Towering Inferno," "Airport 1975," "Earthquake," and "Deathwish." The public is attempting to soothe its tattered nerves by concentrating on somebody else's disasters. (Note: Frankenstein and Dracula were both produced in 1932, with the market at its lowest level in modern history).

Nevertheless, in the face of all these dark clouds, economic, political and social, I have pointed out to subscribers that the stock market seems to be marching to the beat of a different drum. The D-J Industrial Averages smashed to their lowest joint levels of the bear market on October 3, 1974. On December 4 (Letter 616) I changed the format of this report while stating that I was no longer willing to predict lower prices or a continuation of the bear market. Whether I was acting from intuition, common sense, California optimism, or a message from above, I cannot say, but in that mailing I said that from here on the market was going to have to prove to us that it was still headed down. The new page 1 chart (beginning in Letter 616) included seven averages and indicators, and I wrote that if the bear market was to continue, we would certainly receive signals and downside confirmation as the various indicators peeled off and headed to new lows.

Nothing of the kind occurred. On the contrary, the Transports, Utilities and Bonds refused to confirm new lows made by Industrials on December 6. Next, all the averages (including Industrials this time) refused to confirm the new lows recorded by the A-D ratio and the Primary Trend Index on December 23.

In the December 20 Special Report and again in the Letter of January 2 (#618) I outlined in orthodox Dow Theory terms why the refusal of the Transports to confirm the December 6 Industrial low was a phenomenon of great significance (see page 1 chart). The stage, it seems, was being set for a major market reversal. On December 31 the A-D ratio turned up with a vengeance, and the entire market surged higher. The various technical indices provided encouragement as the advance got underway.

On January 2 the A-D ratio reversed its declining trendline, a trendline that has held in force through most of 1974. On January 2 the Primary Trend Index completed a bottom and broke above a year-long declining trendline. On the same day the most-active stock index moved into plus territory (meaning that the 8-day plurality of the most active stocks rose above zero, an indication of ongoing accumulation).

All very well, and it is certainly more hopeful than anything seen since the 1973 peak. But the big picture, as far as I am concerned, boils down to the question of whether the D-J Industrial and Transport Averages will better their primary points on the upside. These points are the November highs of 674.75 for Industrials, 156.61 for Transports (page 1 chart). If these two points are jointly bettered, then I will call a new primary bull market. A primary bull signal would also mean that the Averages, at their October and December lows (along with a majority of stocks) had discounted the worst of any recession, or even a depression, that may lie ahead.

I might as well add that it is not necessary for both Averages to better their primary or bull signal points on the same day or even the same week or month. But as a rule, the closer together (in time) the penetrations, the greater the validity of such a signal. Increasing volume on upside penetrations would also heighten the validity of a bull signal.

So far in 1975 we have been experiencing (and I am talking about those of us who purchased common stocks as outlined in the Special Report and again in Letter 618) the most profitable of all market phenomena, the "breadth explosion" or "investment stampede." On the week ending January 3 we saw the NYSE produce an amazing 1693 advances as against only 203 declines, a ratio of 8.4 issues

up for every 1 down. Last week (week ending Jan. 10) we had 1670 advances and 242 declines for a ratio of 6.9 on the upside.

In other words, everything that could go up did go up. The characteristic of a breadth stampede is that the A-D ratio continues to push up day after day with only slight hesitations or corrections. In the past we have had breadth stampedes that have lasted as long as three months (i. e., 1958) before the first phase of the stampede ended. It is also worth noting (1) that breadth stampedes almost always occur in the early phases of bull markets, and (2) breadth stampedes since World War II have tended to come in groups of more than one — usually three. Thus, if history repeats we could have a series of three breadth stampedes during 1975 with the whole phenomenon lasting a number of months.

Question: What causes a breadth stampede? **Answer:** A tremendously depressed and over-sold market, a market in which the majority of stocks have simply gone down "too far." The realization of this undervaluation (which produces great values) sets off a stampede to get aboard — all of which leads to a prolonged and persistent advance in the A-D ratio. The breadth stampede phenomenon is literally an upward revaluation of the entire market as it reflects changed conditions for equities and business in the period ahead.

Question: How do you identify the end of a breadth stampede? **Answer:** I consider each phase of a breadth stampede over when the A-D ratio drops one point or more from its last peak (see chart). So far, the A-D ratio has been heading steadily upwards and away from its December 30 low. As of this writing the initial phase of the stampede is intact.

Question: What kind of danger signals will you be looking for in this market?

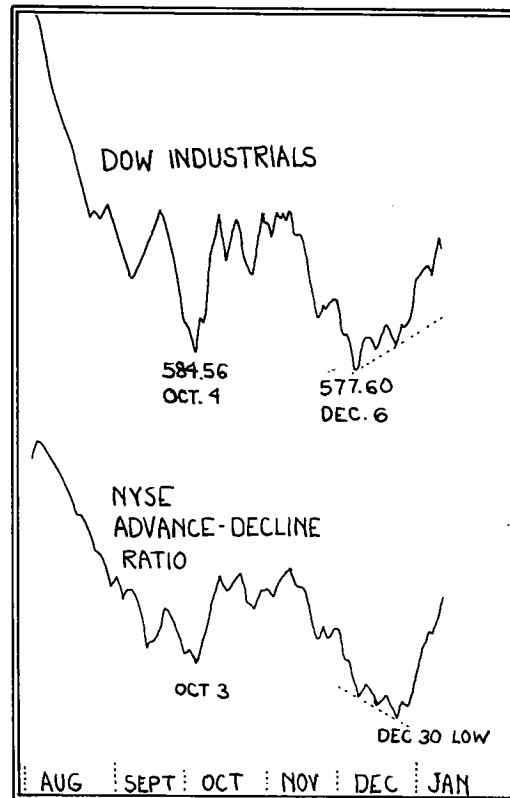
Answer: The same kind I always look for, but first I will be watching to see whether one or both Averages (Industrials or Transports) refuse to better their November peaks. Next I will be watching daily action for non-confirmations between Industrials and Transports or between Industrials and the A-D ratio or the PTI. It is well to note that rallies in bear markets tend to produce divergences as well as a lack of unanimity among the various technical indicators. True bull market rises tend to produce sweeping "in gear" up-moves. We began to see upside unanimity in the indicators in the January advance, and I have already received three 100% up-days in my PTI in January (Jan. 6, 9, 10), a real rarity over the past few years. This is true power. Let's hope it continues.

Question: Russell, you talk about a bull market. Could you have lost your marbles? Do you read the papers? We're going into a depression, aren't we? **Answer:** In the Special Report of December 20 I noted that the unweighted NYSE average of all stocks was down 77% from the high (compared to 89% or only 12% more in 1929-32). That kind of action was obviously predicting something more than a little downside blip in the economy, or so it seemed to me. But the point is that at the October-December lows, the market may have DISCOUNTED the worst. After all, the July 8, 1932 Dow low of 41.22 discounted a great depression, but the Dow never went lower despite a decade of hard times (in fact a bull market began in 1932). The two most important market questions now are (1) Did the Averages discount the worst at the October lows? (2) Will Industrials better 674.75 and Transports 156.61, thereby rendering a Dow Theory bull signal?

Question: You seem to think that you know more than the best brains in Washington regarding the troubles ahead. When did you become an expert economist? **Answer:** I have my own opinions that are probably no better or worse than the next fellow's. But I do consider myself proficient at "reading" the market. Once again I'll remind subscribers that the market represents the sum total of what everybody knows about everything. The analysts' graveyard is piled high with the corpses of soothsayers, advisory writers, crystal ball gazers and boardroom geniuses who have insisted that they knew more than the market. I suppose you have to spend fifteen to twenty years working at this business before you get full respect for the discounting ability of Wall Street. Since World War II the market has moved ahead of the economy with a lead time of approximately six months to a year, and lately (as investors and institutions have gained in sophistication) the lead time has tended to be generally in the one-year area.

Question: If we get a bull signal, will this mean that the economy is going to turn up in 1975? **Answer:** Not necessarily; interestingly enough, many economists now offer widely differing opinions on what lies ahead for business. But remember, you make money in this business by being right on the stock market, not by being right on the FRB Production Index. Even so, I find it fascinating that two of the brightest analysts, Tom Holt (Holt Advisory) and economist S. Jay Levy (Industry Forecast) are now at opposing ends of the poles. In his latest report, Holt sees 1975 as a rough year with "consumer spending in general and retail sales in particular" suffering "the worst slump since the Great Depression."

On the other hand, Levy, in his most recent report, states that "The recession of industrial production, corporate profits and employment will be shallow in comparison with their trends during other periods of business contraction." And I ask myself, suppose Levy's astoundingly optimistic forecast (and Levy has been very, very good in the past) is correct? Suppose that the economy even bottoms



Page 4 out in the first or second quarter of 1975? Investors would be caught with their stock larders empty. There could be a panic to buy. Is that what the market is telling us now? It's worth pondering.

Question: Good Lord, what can I do with that kind of opposing Holt-Levy thinking? Answer: Nothing really, except work up a sweat. But remember, the market acts on what people expect in the period ahead, and there have been times when the market protected itself against situations that did not materialize. One such example was the 1962 crash, in which the market insured itself against a business smash that never came. By the same token, the market, if it rises during 1975, could conceivably be discounting a business expansion that would not materialize.

Question: What other reason would the market have for advancing during 1975? Answer: If the Fed pumps away in an effort to get this economy rising, it is possible that they may only spur inflation or help liquidity somewhat, but they may fail totally in helping business. Short term interest rates are now coming down (which means less attractive T-bill, C/D and commercial paper yields), and at the same time investors are still leery of long term bonds. On the other hand, many good stocks are now in the 8% to 12% dividend yield area, and many of these dividends are well covered. What we could be seeing now is a rush to "lock in" some of these fantastically depressed stocks with high dividends. As I said in the last report, the only totally deflated area of the economy is the stock market.

If the worst has been discounted, the market has only one way to go — up. Such a move could produce at least a mini-bull (even in the face of a steadily declining business picture). The mini-bull could come for no other reason than that stocks will move up from under-valuation to reasonable valuation (which is about what happened in 1932-37). Note that almost all the stocks that I have recommended in recent Letters (1) are 50% to 90% under their highs, (2) are providing high yields, (3) have low P/E ratios and have good chances of holding their dividends.

Question: Russell, many of your fellow analysts are saying that the best we could have (even with a primary bull signal) is a rally in a bear market or a mini-bull market. What do you think? Answer: Pride goeth before a fall. I'll say again, that in this business, you either get humble or you get your walking papers. The extent and duration of a primary movement cannot be predicted in advance. I have no idea where this market is going if we get a bull signal. My intuition tells me that it will do what it has to — to shock the greatest number of people. We could have a three month fizzle or an historic rise. But for the sake of argument, suppose the Dow's earnings are down 20% next year to \$80, and because of massive new deficits and a rush to hedge against inflation, investors put a "15-times" price ratio on the Dow. That would give us a Dow of 1200. Improbable, absurd, unlikely? Sure, but impossible — I'll leave that to the geniuses. I just follow the market trends, while trying to teach my subscribers correct market procedure. It's not my job to play God on Wall Street.

Question: What about gold as a hedge against inflation? Isn't gold still the best hedge? Answer: My business is not telling people what they want to hear, it's relaying to them what the market wants them to hear. For months now I have been indicating to subscribers that something has changed. Gold is not acting like an inflation hedge. Gold relative strength peaked against the market in August, 1974. Was that the top? I don't know. I believe in gold fundamentally, I really do, but I'm not a damned fool. The market told me that investors were moving elsewhere for their inflation hedge. That "elsewhere" seems to be common stocks. Everything is timing in the market. Stocks move up and down, but our job is to figure out when. If we get a Dow Theory primary bull signal, I would say that the market is telling us that at least for a time, the hedge, the action, the move, will be to common stocks. You refuse to believe it? You can't believe it? Be my guest, go argue with the market. The fact is that it IS POSSIBLE that gold, by moving from \$35 an ounce to last month's peak of \$197.50 an ounce, discounted the worst of inflation (as far as gold is concerned).

I'll say it again, I see nothing wrong with keeping a 25% hedge (half coins, half gold shares) against a world catastrophe. But for now, the play is in the market, and that's where I am. The minute gold or gold shares heat up again, my subscribers will know it. I promise you.

ADVANCE-DECLINE RATIO: I learned most of what I know about market breadth, commonly known as the advance-decline ratio, from James Hughes of the old Auchincloss, Parker, Redpath Company (NYSE members). Hughes, along with Colonel Ayres of the Cleveland Trust Co., invented the A-D ratio back in the 1920's. I obtained many of my historical charts of the ratio from Hughes, and I guess my collection of various A-D graphs are as extensive as any in the nation. I have always been intrigued by the relationship between price and breadth (i.e., the Dow and the A-D ratio), and I'll bet I've burned up literally hundreds of man hours pouring over my breadth charts in an attempt to glean every possible bit of knowledge from them.

In general, I would say that the A-D ratio (which measures the advancing and declining tendencies of all NYSE issues) along with the study of the three Dow Averages (Industrials, Transports, Utilities) form the basic weapons in my technical arsenal, the mainstays without which I would be lost.

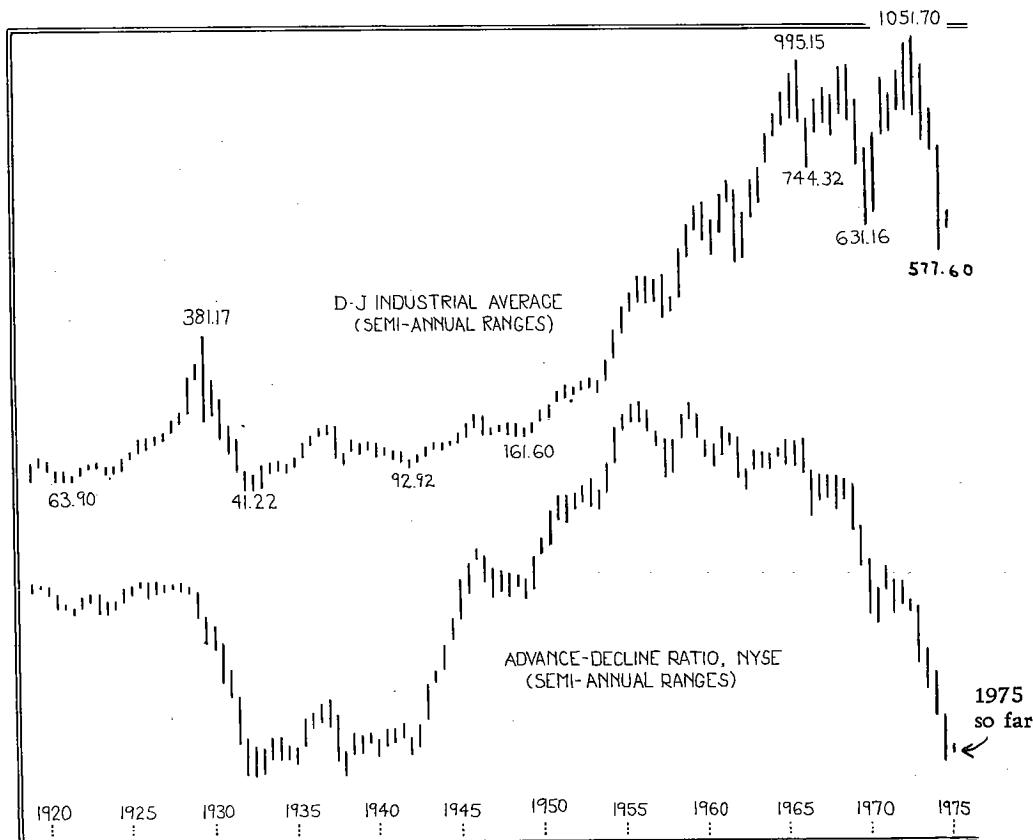
Every year or so I include this rare, long-term chart of the Dow Industrials and the A-D ratio. This is a chart showing semi-annual high-low ranges for the two indicators (in other words, two vertical bars for each year). What this chart is showing is, to my mind, just short of fantastic. It could be telling the most important financial story of 1975. Why am I excited about the A-D picture? I will give my reasons below.

(1) As of the recent December, 1974 low, the A-D ratio broke to within a fraction of its all-time low recorded in 1932. Note that a "double bottom" on the A-D ratio was recorded in 1932 and 1938. The 1932-38 level would seem to represent an area of tremendously strong support here in 1975.

January 15, 1975

and continued up to a final peak in 1956. That represented a bull market of 24 years in the A-D ratio. Following 1956, the A-D ratio continued down to the December, 1974 low. That represented a bear market of 18 years. The bear market in breadth lasted 75% as long as the bull market. That is an extraordinarily long time for a bear market to last in relation to the preceding bull market (most bear markets are 1/3 to 1/2 as long as the preceding bull market).

(3) In both duration and extent, the collapse of the A-D ratio since 1956 has been of breath-taking proportions. Based on my previously mentioned observations, I believe that there is a good chance that December, 1974 saw the bottom of the bear market in the A-D ratio. If so, we could very conceivably be in for a rise in the A-D ratio of the 1932-37 or the 1942-46 variety. Both of these advances were spectacular, particularly that of 1942-46 when almost everything on the Board moved up from the vastly depressed levels of early 1942.



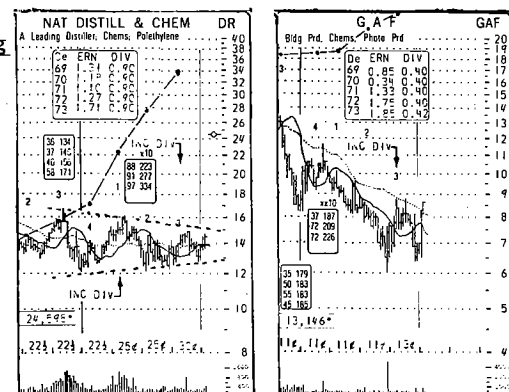
I don't particularly like making predictions in this business, because it seems to me that there is a certain amount of arrogance inherent in any prediction about the stock market. But I do feel that it is a real possibility that we will never again in our lifetime see the A-D ratio down at the depressed levels of December 1974. Those same levels measured the worst of the Great Depression in 1932; those levels in 1938 measured the coming horror of Hitler, World War II, and a civilization that very nearly went under. Perhaps at the December, 1974 level, the A-D ratio was discounting the worst of a world beset by illiquidity, inflation, unemployment, fiat money and political incompetence. Remember, once you discount the bottom, there is nothing left to do but start discounting the next top.

STOCKS: The early stages of a massive upward breadth move is generally non-selective in that the great majority of stocks are lifting off their depressed lows. That is what we have been seeing over the past few weeks to months. Then, if it is to be a true bull market (and therefore a continuing rise), we get revolving strength with first one group, then the other moving up. Strong groups now include building supplies, chemicals, glass and metal containers, canned foods, tobacco, among others.

This whole stock market advance has, so far, been explosive, and in the last report I suggested that subscribers move into recommended shares to the tune of no more than 15% of total capital. I might as well say now that I will not recommend more than 40% or at most 50% of available funds to be put in the stock market, even if we get the primary bull signal I have been directing so much attention to. The reason for this is that the overall, long-term fundamentals of the situation have not changed. There is only one way out of this recession, and that is Government manipulation leading to later super-inflation. We are already on the path and the bond markets are telling us that loud and clear as they surge in response to lowering interest rates.

I personally believe that we are now going into one of the most difficult and fast-moving periods of our investment life. To argue with the market in this period is going to be disastrous. I know the fundamentals, you know them, everyone knows them. So don't write me letters telling me how bad the picture is, I know all the minuses. But more than ever in eighteen years of writing these reports I am going to listen to the market, and right now it's saying "up."

Three stocks I want to recommend now are Ogden, National Distillers and GAF. The first two have the remarkable record of being higher during the year 1974. Often, stocks that won't go down in a disastrous year want to go up. I think Ogden and National Distillers do. The chart of Ogden shows a double bottom at 11½, then the breakout this week at 16. I think it's a buy now (note rising relative strength line or ratio-cator). Ogden's earnings are excellent and the company has been increasing dividends. Ogden



Page 6 enjoys excellent management. National Distiller is pushing out of a big triangle, and it looks good technically. The \$1.20 dividend offers a 8.2% yield (triple covered), and I like this stock very much. Finally GAF (formerly General Aniline Film) just turned up on long-term relative strength after a three-year decline. The stock earned \$2.26 on the latest annualized earnings and pays a 52¢ dividend, yielding about 6% at 8½. At 9 or above, GAF "breaks out" and I think this stock has real potential (having sold about 50 in 1972). Charts of Ogden courtesy of Sec. Research, 208 Newbury St., Boston MA 02116. Charts of DR and GAF courtesy of Quote, PO Box 213, Wichita KS 67201.

GOLD: My daily chart of Gold (below) shows bullion below the two moving averages. What I am watching is the building of a possible "head-and-shoulders" top with support at around 172-74 (X on the chart). If gold breaks this level, I believe it could test its rising trendline that now comes in at about 162 (Y on chart). If it breaks 162, gold could test the 150 level. At the bottom of the page I include a tracing of a monthly chart that just arrived from my friends at Ray*Signals, 43 Lake Ave., Montrose PA 18801. The chart shows the Gold Average breaking below a two year trendline. Relative strength of gold has now cracked and this is confirmed by the 6-month momentum of relative strength.

Everything is timing in the market. This chart confirms what I have been saying regarding the inflation hedge, that has now switched away from gold and to common stocks. I have no doubt that gold bullion and shares will be a buy within a year or so — and perhaps sooner. But the timing is the crucial thing, and this chart is saying that for the foreseeable future, gold shares are not going to move with the market.

Meanwhile, my gold momentum chart is hanging on the edge, but I would have to say that it is just about breaking down. If bullion slips under the 178 level in the coming week, then my momentum chart has definitely broken down, indicating lower prices for gold.

In spite of all this, I repeat that subscribers who have followed my advice and cut down to 25% gold items (half in coins and half in shares) can sit tight with this conservative commitment. Gold will come back, and I will keep subscribers abreast of the technical picture. But this is not the time to be stubborn, to be emotional, to try to prove that you know what the market "has to do." The market can do anything, and that includes the gold market.

Wall Street has always known that its "babies" do only two things; they move up and they move down. Our job, our greatest job, is to answer the single question, "When?"

LATE NOTES: The S & P 500 was up 2.5% for the first five days in January, the third highest "first five days" gain in 25 years. Yale Hirsch's Stock Market Almanac attaches great significance to the first five days' action. In the other top first five days gains (1967, 1963, 1958, 1951, 1950) the S & P gained an average of 23% by year's end. We'll see if the first five days formula holds for 1975.

The A-D ratio performance here is absolutely extraordinary, and I am going to say that subscribers are entitled to move up to about one-third invested in this market at their own discretion. I have never seen a market with this kind of upside breadth top out in less than six months.

The London market hit a fantastic low (on news) of 146 last week. Then it rebounded strongly. My guess is that London has now discounted the worst.

I've never received as many letters as I have in the past week or so. Sorry, but I simply cannot answer them all.

